APPENDIX "A"—JUDGMENT OF COURT OF APPEALS

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the twenty-eighth day of March one thousand nine hundred and seventy-four.

PRESENT:

HON. IRVING R. KAUFMAN, Chief Judge
HON. J. JOSEPH SMITH,
HON. ROBERT P. ANDERSON

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

In the Matter of
Marcel Freudmann,

Bankrupt-Appellant,

Joseph Blankstein,
trustee of the Estate of
Marcel Freudmann,

Trustee-Appellee.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said District Court be and it hereby is affirmed with costs to be taxed against the appellant.

A. DANIEL FUSARO, Clerk

By VINCENT A. CARLIN
Chief Deputy Clerk

APPENDIX "B"—DECISION

(SAME TITLE)

Before:

KAUFMAN, Chief Judge,
SMITH and ANDERSON, Circuit Judges.

Appeal from an order entered in the United States District Court for the Southern District of New York, Murray I. Gurfein, Judge, denying a petition for review of an order entered by Bankruptcy Judge Asa S. Herzog which denied a discharge in bankruptcy.

Affirmed.

SAMUEL B. OHLBAUM,
New York, N.Y.
for Bankrupt Appellant.

A. THOMAS LEVIN, New York, New York
(Jaspan & Kaplan, New York, New York
on the brief), *for Trustee-Appellee.*

PER CURIAM:

Although the decision below was affirmed in open court, we are of the view that it is appropriate for us to memorialize that disposition in a written opinion.

Marcel Freudmann appeals from Judge Gurfein's denial of a petition for review of an order denying Freudmann a discharge

in bankruptcy entered by Bankruptcy Judge Herzog. The testimony presented before the bankruptcy court established that for at least one year preceding the filing of an involuntary petition in bankruptcy on May 28, 1970, Freudmann, a diamond merchant, engaged in a calculated scheme to purchase diamonds on credit and immediately to sell them, for cash, at prices below cost. In effect, Freudmann was "kiting" diamonds by using the proceeds of his cash sales to meet notes as they fell due. As a result of this consistent pattern of transactions, Freudmann incurred debts of $107,315, from May 1, 1969, to April, 1970. Freudmann did not deny these activities; indeed, in his testimony before the bankruptcy court, Freudmann admitted the essential facts of this "Ponzilike" scheme, as the bankruptcy judge characterized it, but disclaimed any fraudulent intent.

After several hearings, Bankruptcy Judge Herzog found that the pattern of Freudmann's behavior evidenced actual intent to defraud the creditors "at the end of the line" and, accordingly, denied Freudmann his discharge. 11 U.S.C. 32(c)(4).[1] Subsequently, Judge Gurfein, in a well-reasoned opinion reported at 362 F. Supp. 429 (S.D.N.Y. 1973), found that the evidence supported the bankruptcy judge's finding and denied Freudmann's petition for review. After studying the record of

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1. Section 14(c)(4) of the Bankruptcy Act, 11 U.S.C. 32 (c)(4), provides:

> (c) the court shall grant the discharge unless satisfied that the bankrupt has . . . (4) at any time subsequent to the first day of the twelve months immediately preceding the filing of the petition in bankruptcy, transferred, removed, destroyed, or concealed, or permitted to be removed, destroyed, or concealed, any of his property, with intent to hinder, delay, or defraud his creditors.

proceedings in both the bankruptcy court and the district court, we agree that the clear pattern of purposeful conduct amply supported a finding of actual intent to defraud. Once the evidence established "reasonable grounds" to believe that Freudmann committed acts to hinder, delay, or defraud his creditors, the burden of proving that he had not committed such acts shifted to Freudmann. 11 U.S.C. 32(c). We do not believe that the courts below erred in finding that Freudmann's mere denials of fraudulent intent fell short of sustaining his burden. Accordingly, we affirm.

APPENDIX "C"—DECISION RE: DISCHARGE

(SAME TITLE)

APPEARANCES:

JOSEPH JASPAN, ESQ.
Attorney for Trustee
By: ARTHUR JASPAN, ESQ., of counsel

SAMUEL NEWFIELD, ESQ.
Attorney for Bankrupt

ASA S. HERZOG, Referee:

An involuntary petition was filed against the above-named bankrupt on May 28, 1970 and he was adjudged a bankrupt on June 4, 1970. The trustee in bankruptcy filed five specifications of objections to his discharge. After trial, Specification No. 4, charging that bankrupt obtained money by means of a false financial statement [Bankr. Act §14c(3)] was dismissed because trustee failed to sustain the burden of proof. Specifications Nos. 1, 3 and 5 were withdrawn. (SMP 100, 130)

The remaining specification, No. 2, charged:

> "That on and after May 29, 1969, subsequent to the first day of the 12 months immediately preceding the filing of the petition, the bankrupt transferred certain of his property, to wit: diamonds, to U. Doppelt, Doppelt & Co., William L. Lewey, Inc., and others for inadequate consideration with intent to hinder, delay or defraud his creditors". [Bankr. Act §14c(5)]

The gist of the misconduct charged is that the bankrupt, a diamond merchant, purchased diamonds on credit and promptly sold them below cost for cash.

There is no doubt that the bankrupt did just that. He conceded that he entered into various transactions "which resulted in sales below cost". (SMP 114)

While the testimony of the trustee's accountant shows a gross loss of sales of $303,000 for the period April 1, 1969 to May 28, 1970, (SMP 108) I do not think that is particularly relevant in view of withdrawal of the specification charging a failure to explain satisfactorily losses and a deficiency of assets to meet liabilities.

What is important, and the nub of trustee's case, is that the trustee was able to match purchase and sales invoices which showed that from May 1, 1969 to April, 1970, the bankrupt bought diamonds on credit for $521,546, which he sold for $414,231, thereby suffering a loss of $107,315.* (SMP 105)

Detailed schedules of purchases and sales for the period were introduced in evidence as trustee's Exhibit 16, (SMP 106) and a summary thereof as trustee's Exhibit 17. (SMP 107).

The losses sustained during the critical period, in and of themselves, are meaningless, with relation to the specification charging transfers with intent to hinder, delay or defraud creditors. But they do become meaningful when examined as separate transactions.

*Some $340,000 in purchase invoices could not be matched with sales invoices.

Some glaring illustrations make the point clear:

1. An invoice from K. Lebendiger & Son, dated September 9, 1969, shows 9.18 carats sold to bankrupt for $1285.20. A matching invoice, dated September 6, 1969, shows a sale of the same number of carats by bankrupt to William L. Lewey, Inc. for $918.00. (SMP 85)

2. An invoice from Emanuel Burton Diamond Co., dated March 31, 1970, shows 34.09 carats sold to bankrupt for $4,932.05. This is matched by an invoice, dated March 11, 1970, to William L. Lewey Inc. for $3,599.45. (SMP 86)

3. As invoice from Emanuel Burton Diamond Co., dated April 21, 1969, for $51.56 carats sold to bankrupt for $9,021.25, is matched by an invoice to the same Lewey Company, dated April 15, 1969, for $6.071.10. (SMP 86)

4. An invoice from E. Mandel, dated September 2, 1969, for 3.66 carats, sold to bankrupt for $1,976.40, is matched by an invoice to the Lewey Company, dated the same day, for $1,688.20. (SMP 86)

5. An invoice from K. Lebendiger & Son, dated October 3, (or 5), 1969 for 42.84 carats, sold to bankrupt for $5,511.92, is matched by an invoice to Lewey, dated September 23, 1969 for $4,369.68. (SMP 87)

6. An invoice from Lubell & Ray Inc., dated November 3, 1969, for a total of 13.71 carats, sold to bankrupt for $5,427.60, is matched by an invoice to Lewey for a like number of carats October 29, 1969 for $4,242.90. (SMP 87)

7. An invoice from Sokolnik Bros., dated March 12, 1970 for three items totalling 29.68 carats, sold to bankrupt for $8,290.75, is matched by an invoice to Lewey, dated March 10, 1970, for the same number of carats, for $6,438.95. (SMP 87)

8. An invoice from Schupf Company, dated April 13, 1970, shows a sale of five items aggregating 56.01 carats to the bankrupt for $15,253.70. This is matched with bankrupt's invoice (undated) for like number of carats, to Lewey, for $11,314.02. (SMP 88;

9. An invoice from Meizlik, dated February 26, 1970, for $6,222.40, is matched by an invoice dated February 16, 1970, to Lewey for $5,478.50.

There are other like transactions between the bankrupt and Lewey, but the illustrations above given should suffice to show a clear cut pattern of conduct on the part of the bankrupt. There were, additionally, a series of transactions between the bankrupt and one U. Doppelt, which are considerably more shocking in the variance between cost and sales prices:

10. An invoice from S & M Kaufman, dated May 1, 1969, showing a sale to bankrupt for $57,095.25, is matched by an invoice to Doppelt, dated April 18, 1969, for $39,620.00. (SMP 49-52)

11. An invoice from Martin Strets to bankrupt, dated January 22, 1970, for $29,460.00, is matched by an invoice to Doppelt, dated the same day, for $20,000. (SMP 54-55)

12. An invoice from Lubell & Sax, Inc. to bankrupt, dated April 1, 1970, for $13,068, is matched by an invoice to Doppelt,

dated March 20, 1970, for $8,000. (SMP 56)

13. An invoice from A.M. Polak & Co. to bankrupt, dated April 20, 1970, for $17,130. is matched by an invoice to Doppelt, dated April 17, 1970, for $13,500. (SMP 61)

14. An invoice from I. Wiatre to bankrupt, dated May 1, 1970 for $1,521. is matched by an invoice dated April 24, 1970 to Doppelt for $1,001. (SMP 66, 71)

15. An invoice from Miscel, Ferman, Roysen & Ferman, to bankrupt, dated June 6, 1969, for $28,072.97, is matched by an invoice dated June 3, 1969 to one Bert Sidel for $22,604.40. (SMP 81)*

I do not deem it necessary to give further instances of what was clearly a pattern of behavior on the part of the bankrupt. When the pressure of his debts became unbearable (SMP 114), and the need for cash was "desperate" (SMP 115), the bankrupt embarked upon a course of conduct, taking diamonds on "memo", selling them for whatever he could get in cash, and then paying his vendor with promissory notes. That he held the stones on "memo" is clear to me from the fact that in almost every instance the invoice to the customer predated the invoice received from the vendor.

In my opinion, these sales by the bankrupt were transfers clearly made with intent to defraud the vendor-creditors. To fall within the ambit of §14c(5), the fraud need not be of all of bankrupt's creditors. It is sufficient if it was intended to defraud

*The recital of the fifteen transactions constitute findings of fact.

a single creditor. *Michael Kolesinski v. Steve Mashley,* 127 F. 2d. 528 (2d Cir. 1942). In this case I find that the bankrupt practiced a fraud on each and every creditor from whom he obtained diamonds on credit, which he promptly sold at a considerable loss for cash.

Bankrupt argues that the proof of fraud should be "specific". (SMP 111) With this I cannot agree. Proof of intention with which property is disposed of can rarely be directly established. *In re Luber,* 152 Fed. 492 (E.D.Pa. 1907). Actual intent may be established by direct evidence or by presumption if the acts are committed with knowledge that they will operate to hinder or delay creditors in the enforcement of their rights. *In re Geo. Lampros. Inc.,* 18 F. 2d 633 (D. Mass. 1927). Failure of consideration would be something from which an intent to defraud might be inferred. *In re Goumas,* 51 F. 2d 126 (W.D.N.Y. 1931).

A single transaction of selling below cost would be understandable, and bankrupt's claim that he did not intend to defraud might be acceptable. But an entire series of such transactions is the clearest indication of an intention to defraud. Instead of kiting checks, the bankrupt was in effect kiting diamonds, using the proceeds of his below-cost sales to meet various notes as they fell due. (SMP 117). As in all kiting schemes, there came a point when the pressure built up and he could no longer meet the note payments. (SMP 121, 122)

The series of transactions constituted a definite, planned scheme, and no motive other than to defraud the vendor-creditors can be deduced from acts so egregious as have been established here.

Accordingly, I find that during the period subsequent to the first day of the twelve months immediately preceding the filing of the petition in bankruptcy herein, the bankrupt transferred certain of his property consisting of diamonds to various persons, to wit: William L. Lewey, Inc., and/or William Lewey, and one U. Doppelt, of the value in excess of $200,000., with intent to defraud certain of his creditors, including K. Lebendiger & Son, Emanuel Burton Diamond Co., E. Mandel, Lubell & Ray, Inc., Sokolnik Bros., Schupf Company, Meizlik, S. M. Kaufman, Martin Strauss, Lubell & Sax, A. M. Polak, I. Wiatre and Mischel, Ferman, Royson & Ferman. I find and conclude that the bankrupt was accordingly guilty of conduct which, pursuant to Bankr. Act §14c(4), bars his discharge.

Specification No. 2 is sustained and discharge will be denied. Settle order in conformity with the foregoing on three days notice.

DATED: New York, N.Y. June 3, 1971

REFEREE IN BANKRUPTCY

APPENDIX "D"—DISTRICT COURT'S DECISION

(SAME TITLE)

GURFEIN, D. J.

This is a petition to review an order by Referee Asa S. Herzog denying a discharge in bankruptcy and denying a motion to reopen the hearing for the submission of further evidence by the bankrupt. Since the denial of a discharge under §14c of the Act is a "most punitive measure," *In re Ostrer*, 393 F. 2d 646, 649 (2 Cir. 1968), the bankrupt should be given every opportunity to meet the burden cast upon him under that section (11 U.S.C. §32c). The Referee found fifteen separate instances in which the bankrupt took diamonds on "memo," sold them for whatever he could get in cash and then "paid" his vendor with promissory notes. The Referee concluded that these sales by the bankrupt were transfers clearly made with intent to defraud the vendor-creditors.

After the opinion of the Referee and before entry of his order, the bankrupt requested an opportunity to submit proof on the background facts respecting the transactions specified in the opinion in an effort to establish that the bankrupt had no fraudulent intent as to the creditors from whom he purchased diamonds on such transactions. The Referee denied the request to reopen the proceedings.

On this petition for review, the bankrupt submits that the proceedings be referred back for the submission of additional testimony by the bankrupt on specification 2. That specification was the only one sustained and on which the denial of discharge was based.

Specification 2 reads as follows:

> "That on and after May 29, 1969, subsequent to the first day of the 12 months immediately preceding the filing of the petition, the bankrupt transferred certain of his property, to wit: diamonds, to U. Doppelt, Doppelt & Co., William L. Lewey, Inc., and others for inadequate consideration with intent to hinder, delay or defraud his creditors." [Bankr. Act §14c(4)].

The bankrupt offers to attempt to prove in the proceeding that the fifteen findings made by the Referee did not take into account circumstances which were not in the record before him. He contends, in short, that two of the transactions occurred more than 12 months prior to the bankruptcy; that of the thirteen remaining, in four of the transactions the matching of purchases and sales was incorrect; that in four of the transactions the vendor was paid in full; that in two transactions a substantial part of the sales price was paid to the vendors. He appears to concede with respect to the seventh, ninth and twelfth findings that the facts were correctly found.

I cannot determine what significance, if any, these "corrections," if proved, will have upon the essential finding of actual "intent to hinder, delay or defraud his creditors." *In re Fioch*, 235 F. 2d 903 (3 Cir. 1956); *In re Nemeroy*, 134 F. Supp. 678, 680 (S.D.N.Y. 1955). I believe that an ultimate conclusion should not be reached, however, until the supporting findings are quite clear. I would like the learned Referee to take further evidence and make his findings, including an ultimate finding, thereon. The matter will then be ripe for review. The order denying discharge is reversed pending such further disposition.

It is so ordered.

M. I. GURFEIN
U.S.D.J.

Dated: January 10, 1972.

APPENDIX "E"—DECISION ON REHEARING ON DISCHARGE

(SAME TITLE)

APPEARANCES:

JASPAN, KAPLAN & JASPAN, ESQS.
y: ARTHUR W. JASPAN, ESQ., of Counsel
Attorneys for Trustee

OTTERBOURG, STEINDLER, HOUSTON & ROSEN, ESQS.
By: CONRAD B. DUBERSTEIN, ESQ., of Counsel
Attorneys for Bankrupt
and
SAMUEL NEWFIELD, ESQ., of Counsel
Attorney for Bankrupt

ASA S. HERZOG, Referee:

The bankrupt was denied his discharge by order dated July 12, 1971. A motion to reopen the hearing for the purpose of adducing additional testimony was denied, but on review the matter was remanded with directions to permit the bankrupt to present additional testimony relating to the one specification of objection to discharge which had been sustained.

Hearings were held on March 2, 1972, and April 21, 1972, at which the bankrupt gave the additional testimony which he believes would have persuaded the court to reach a different conclusion.

Denial of the bankrupt's discharge was grounded upon a specification charging that within the twelve months prior to the filing of the involuntary petition in bankruptcy, the bankrupt had transferred certain of his property consisting of diamonds to named persons with intent to hinder, delay or defraud his creditors. [Bankruptcy Act, §14c(4).]

In my decision dated June 3, 1971, I cited 15 instances in which the bankrupt had purchased diamonds which he had on the same day sold to others for sums considerably less than he had paid for them. The earliest of these 15 transactions occurred in April of 1969, and the latest, in April of 1970. The 15 instances cited were not the only such transactions which took place during the critical twelve-months period. They were culled from a number of like transactions established by the trustee, as illustrative of a pattern of conduct on the part of the bankrupt. The trustee proved to my satisfaction at the original hearing that from May 1, 1969, to April, 1970, the bankrupt bought diamonds on credit for $521,546, which he sold for $414,231, suffering a loss of $107,315.

The bankrupt freely admits the acts charged, but claims that he was without intent to hinder, delay or defraud his creditors. In serious financial condition, unable to meet maturing notes, he found a way to raise the necessary cash by purchasing diamonds on credit, usually giving a series of notes, and promptly selling them below cost for cash. Just as few examples (using round figures): On April 15, 1969, he purchased diamonds for 9021, which he sold for $6071; on April 18, 1969, diamonds purchased for 156,000 were sold for $39,000; on June 3, 1969, diamonds costing $28,000 were sold for $22,600; on April 12, 1970, diamonds which cost $8,290 were sold for $6438. The 15 instances cited and other like transactions all showed the identical

pattern, and in each case the purchase and sale occurred on the same day.

From the testimony adduced at the original hearing I concluded that the sales below cost, established as a course of conduct over a period of a year and up to the eve of bankruptcy, were transfers made with intent to defraud the vendors and fell within the ambit of §14c(4).

At the rehearing, the bankrupt took great pains to explain that in every instance he became the owner of the diamonds before he sold them. The procedure, as outlined by him, was as follows: He would approach a vendor and take diamonds on "memo" upon which was noted the selling price. He would then attempt to sell the diamonds for the best price he could get. When he obtained an offer, he would return to the vendor and ask him to lower the selling price. It was not shown that in any one instance his request was granted. He then negotiated terms with the vendor, in most cases a series of promissory notes, and on one occasion, on "open account." He would then return to his vendee and turn over the diamonds, receiving a check which he deposited in his business account. In almost every instance, the invoice received by the bankrupt from his vendor bore a date subsequent to the date of the invoice the bankrupt delivered to his vendee. The bankrupt's explanation was that this was done at his request in order to give him additional time to meet his notes. This testimony was intended to negate the inference that the bankrupt sold the diamonds while he had them on "memo." I am willing to accept that explanation. The gravamen of the specification is not that the bankrupt sold property that was not his to sell, but that he sold his property for inadequate consideration with intent to defraud his creditors.

At the rehearing, counsel for the bankrupt led him through the details of each of the 15 cited transactions and showed that the promissory notes were fully paid in transactions 1, 3, 4, 5, 10, and 15. But he also showed that some or all of the notes were not paid in transactions 2, 7, 8, 9, 11, 12, 13, and 14. In each of the latter instances the notes fell due when the bankrupt had ceased to do business or after the bankruptcy proceedings had been instituted.

Additionally, the bankrupt testified as to 10 other transactions in which the bankrupt's vendees were several of the vendors in the first 15 instances. The avowed purpose of this testimony was to show that bankrupt's vendors in the 15 cited transactions knew that the bankrupt was selling below cost, since they, as diamond merchants, must have known the true value of the diamonds sold to them, and consequently, must have known that the bankrupt was in financial straits. Incidently, in four of the additional ten transactions brought up by the bankrupt, the vendors were not paid.

As already noted, the bankrupt freely admitted that he indulged in the practice of selling below cost all through 1969 and until May, 1970, when bankruptcy intervened (Rehearing, SMP 166, 167). This he did in order to obtain cash to meet maturing notes (Rehearing, SMP 20). He hoped, during this entire period, to escape from the ever-deepening web by obtaining a loan from his mother-in-law, to whom he was already indebted for about $80,000 (Rehearing, SMP 164, 165). He discontinued the practice of selling below cost when he finally realized that assistance would not be forthcoming from that source (Rehearing, SMP 169).

That, in essence, is the gist of the new evidence adduced by the

bankrupt at the rehearing in order to show that he had no intent to defraud creditors.

Unfortunately, the so-called new testimony failed to achieve the hoped-for results. To the contrary, I am soundly convinced that the bankrupt's course of conduct was calculated to and did defraud his creditors. Counsel for the bankrupt argues at some length in his brief that actual fraud as distinguished from constructive fraud must be established. That is quite true, and it is actual fraud that I find present, not in any isolated transaction, but in the entire series of transactions, in a course of conduct dating back at least one year prior to the date of bankruptcy. Although fraud cannot be presumed as a matter of law, inferences may be drawn from the evidence, and the proof may be circumstancial. Intent is seldom proven by direct evidence. It is far more likely to be inferred from the established facts. *Matter of Hochberg*, 17 F. Supp. 916 (D.C. Pa. 1936).

On the question of discharge, the statute clearly spells out where the burden of proof lies. the *proviso* to §14c reads:

> "That if, . . . the objector shall show to the satisfaction of the court that there are reasonable grounds for believing that the bankrupt has committed any of the acts which . . . would prevent his discharge in bankruptcy, *then the burden of proving that he has not committed any of such acts shall be upon the bankrupt.*" (Emphasis added.)

The proof adduced by the trustee satisfied me that reasonable grounds exist for believing that the bankrupt transferred the diamonds in question with intent to defraud his creditors. My "satisfaction" that such grounds existed was not based upon

speculation, conjecture, or suspicions. They were based upon the evidence and the reasonable inferences and presumptions arising therefrom. *Matter of Gottlieb*, 262 Fed. 730 (2d Cir. 1919); *In re Slocum*, 22 F.2d 282 (2d Cir. 1927).

At that point, pursuant to the *proviso* of §14c, the bankrupt had the *burden of proving* that he had not committed the acts charged. The burden of ultimate persuasion that the allegations of the specification were untrue, was his. *Gunzberg v. Johanneson*, 300 F.2d 40 (9th Cir. 1962). This he failed to do either at the original hearing or at the rehearing.

Cases cited by bankrupt's counsel are inapposite. I quite agree that a sale in good faith, for the honest purpose of discharging debts and in the expectation that by so doing a debtor could continue in business, cannot be set aside as a fraudulent transfer, whatever may be the effect on other creditors. (Bankrupt's Brief, pp. 31, 32, 33.) A sale of a portion of an inventory to raise cash to meet a business emergency is not fraudulent because it was below cost. It must be conceded to be a not uncommon business practice. But that is a far cry from a course of conduct running over a year, involving many transactions where diamonds are purchased on credit and sold at a considerable loss for cash on the very same day.

This was a Ponzi-like scheme which was bound to collapse leaving some of the bankrupt's creditors holding valueless promissory notes. The bankrupt is not an unintelligent man. From my observation of him over a considerable period of time, I would say that he is shrewd and of better than average intelligence. He must have known the consequences of his acts. He must have known that a point would be reached where his promissory notes could not be met as they matured. He must

have known that he was embarked upon a course of action which was plunging him deeper and deeper each day into a morass of indebtedness, from which he could not hope to extricate himself. He also must have known, as time went by, that hope of rescue by his mother-in-law was a vain fancy. And yet he persisted to the very end in buying diamonds on what he must have known to be worthless credit and hastily, and the same day, selling at a loss.

The bankrupt testified that he made a profit on a few sales. But those profits were minimal. He said that he approached others in an attempt to get better prices than those he ultimately received, but he could not recall their names. It appears perfectly clear to me that the bankrupt proceeded directly to the same people, in most cases either Lewy or Doppelt, and took whatever they offered for the diamonds. Of course, these people knew they were getting a bargain and that the stones were worth more than they paid for them. And obviously, they knew the bankrupt was in serious financial difficulties, else he would not have accepted their offers. But that does nothing to mitigate what the bankrupt was doing. It is the bankrupt's intent I am concerned with, and from his conduct I find there existed the intent to defraud the creditors at the end of the line. In every kiting scheme, it is those at the end of the line who are defrauded.

It was brought out at the rehearing that during this critical year prior to bankruptcy, the bankrupt withdrew from his business the sum of $66,000 for his personal use. (Rehearing, SMP 172, 173). This went, among other things, for living expenses (Rehearing SMP 176). Considering that he was insolvent and that he was using his creditors' money, this large withdrawal for personal use, fits into the pattern of the reckless and

dangerous course that the bankrupt was pursuing.

I find that the bankrupt has failed to carry his burden of establishing by a preponderance of the evidence that he did not commit the acts charged. Even were the evidence in substantial equilibrium, the discharge must be denied. *Gunzberg v. Johanneson, supra; Morris Plan Industrial Bank v. Schorn,* 135 F.2d 538 (2d Cir. 1943); *In re Barbiere,* 97 F. Supp. 86 (E.D. Pa. 1951), *aff'd* 192 F.2d 1018 (3d Cir. 1951).

Accordingly, I adhere to my original decision and find that the bankrupt was guilty of conduct which, pursuant to §14c(4) of the Act, bars his discharge.

Settle order in conformity with the foregoing upon five days' notice.

Dated: New York, New York
January 19, 1973

s/Asa S. Herzog
REFEREE IN BANKRUPTCY

APPENDIX "F"—DECISION OF GURFEIN J.

(SAME TITLE)

APPEARANCES:

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JASPAN & KAPLAN
Attorneys for the Trustee
New York, N.Y.
By: Arthur W. Jaspan
A. Thomas Levin,
Of Counsel.

GURFEIN, D.J.

This is a petition to review an order of Referee Asa S. Herzog denying a discharge in bankruptcy. After the filing of an involuntary petition in bankruptcy on May 28, 1970, the petitioner was adjudged a bankrupt on June 4, 1970. The petitioner was originally denied his discharge by order dated July 12, 1971. On a review of that order, this Court remanded the matter with directions to permit the bankrupt to present additional testimony relating to the one specification of objection to discharge which had been sustained. At hearings held on March 2 and April 21, 1972, the bankrupt gave additional testimony. Referee Herzog remained unpersuaded, and by an order dated February 7, 1973 again denied discharge. Thereupon the bankrupt filed this petition for review.

The one specification which was sustained alleged:

> "That on and after May 29, 1969, subsequent to the first day of the 12 months immediately preceding the filing of the petition the bankrupt transferred certain of his property, to wit, diamonds to [certain persons] . . . for an inadequate consideration with intent to hinder, delay or defraud his creditors."

The discharge was refused under Section 14c(4) of the Bankruptcy Act, 11 U.S.C. §32d(4).[1]

The learned Referee found many instances where the bankrupt bought diamonds on credit and sold them for cash on approximately the same day at a loss. He specifically found fifteen situations where that had occurred. Referee Herzog held that "the bankrupt practiced a fraud on each and every creditor from whom he obtained diamonds on credit, which he promptly sold at a considerable loss for cash" (1st Op. at 7). He held, as a matter of fact, that "an entire series of such transactions [selling below cost] is the clearest indication of an intention to defraud. Instead of kiting checks, the bankrupt was in effect kiting diamonds using the proceeds of his below-cost sale to meet various notes as they fell due. As in all kiting schemes, there came a point where the pressure built up and he could no longer meet the note payments." *Id.* at 7-8.

The ultimate finding was that "during the period subsequent to the first day of the twelve months immediately preceding the filing of the petition in bankruptcy herein, the bankrupt transferred certain of his property consisting of diamonds to various persons [naming purchasers from him] with intent to defraud certain of his creditors [the vendors]." The conclusion

was, as indicated, that the bankrupt was guilty of conduct which, pursuant to Bankruptcy Act §14c(4), bars his discharge.

On remand by this Court the Referee held a further hearing. Referee Herzog adhered to his earlier decision denying the discharge but he made additional findings. He found that the bankrupt freely admitted the acts charged, but that he claimed that he was without intent to hinder, delay or defraud creditors.

The bankrupt, at the second hearing, testified about ten more transactions in which the persons who bought for cash at a price lower than the bankrupt's cost were the *very* creditors he is charged with defrauding. His purpose was to show that the "defrauded" vendors knew that the bankrupt was selling below cost.

Referee Herzog, conceding that actual fraud as distinguished from constructive fraud must be proved, found "actual fraud" present "not in any isolated transaction, but in the entire series of transactions, in a course of conduct dating back at least one year prior to the date of bankruptcy" (2nd Op. at 6).

Holding that the burden of ultimate persuasion that the allegations of the specification were untrue had shifted to the bankrupt, *Gunzberg v. Johanneson*, 300 F.2d 40 (5 Cir. 1962), the Referee decided that the bankrupt had failed to sustain that burden. On the contrary, the Referee found that "there existed the intent to defraud the creditors at the end of the line" (2nd Op. at 9).

All proceeds of the bankrupt's sales for cash were deposited in his business bank account and used to pay notes held by trade creditors.

The bankrupt relies on the circumstance that some of the vendors themselves actually bought from him at prices below his cost. The thrust of the argument is that the vendors were not defrauded, but knowing of the bankrupt's plight, had charged him prices above the market and had taken a calculated gamble.

In reviewing the fifteen transactions, the bankrupt notes the following: (a) no sales were made of merchandise held on memorandum; (b) all purchases were made on long-term credit at prices which were obviously considerably above the market prices; (c) in at least seven transactions the vendors or creditors were paid in full prior to the bankruptcy proceedings; (d) in two instances of the seven paid-in-full transactions the transactions occurred more than a year before bankruptcy; (e) in three instances payments on account were made; and (f) in the remaining transactions no payments were made because when the payments became due the bankrupt had already ceased doing business or bankruptcy proceedings had been instituted.

The Referee substantially found all these facts, except that he did not find either way on the point that the purchase prices paid by the bankrupt were "obviously" considerably above the market price.

To bar a discharge under §14c(4) there must be an actual intent to hinder, delay or defraud his creditors. See *Halpern v. Schwartz*, 426 F.2d 102, 104 (2 Cir. 1970); *In re Pioch*, 235 F.2d 903 (3 Cir. 1956); *In re Simon*, 197 F.Supp. 301, 303 (E.D.N.Y. 1961), aff'd, 299 F.2d 853 (2 Cir. 1962). Of course, such intent may be proved by circumstantial evidence. See *Burnett v. Medford*, 274 F. Supp. 845 (E.D.Pa. 1967); *Michael Rose Productions, Inc. v. Loew's Inc.*, 143 F.Supp. 606, 608 (S.D.N.Y. 1956); *cf. In the Matter of Moran*, 456 F.2d 1030 (3 Cir. 1972).

"Cash sales of property by the debtor are not prohibited whether made for the purpose of meeting an indebtedness or in the ordinary course of business. Cash sales are clearly transfers but the existence of any fraudulent intent to put property beyond the reach of creditors is strongly negated by the receipt of cash." 1 Collier ¶3.102[2] (footnotes omitted).

Where the claim is that a transfer was made with intent to defraud creditors, the transfer may be shown to have been made for an inadequate consideration. 7 *Remington On Bankruptcy* (1955) §3157. But merely selling inventory below cost to meet maturing debts would not be a transfer with intent to hinder, delay or defraud creditors, as Referee Herzog stated. So, too, if the bankrupt had merely taken diamonds he purchased and given them to a creditor for payment of an antecedent debt that would have amounted to a preference but not necessarily to a fraudulent conveyance. *Hayslip v. Long*, 227 F.2d 550, 553 (5 Cir. 1955). Here, the debtor sold the diamonds and used the proceeds rather than the diamonds themselves to prefer the creditor.

The question is whether the continuous course of conduct of the bankrupt in purchasing on credit and immediately selling for cash at a loss establishes that the bankrupt "transferred, removed, destroyed, or concealed, or permitted to be removed, destroyed, or concealed, any of his property, with intent to hinder, delay or defraud his creditors." Bankruptcy Act §14c(4).

There is no authority cited by the distinguished Referee or by the parties which is directly in point. If the essence of the fraud is the sale for an inadequate consideration, the objective inadequacy of the consideration paid by the purchaser to the bankrupt has not been proved. In a market like the wholesale

diamond market there must, of necessity, be at least two prices, one for sales on credit, the other for cash sales. The former must include what is in effect a premium for credit insurance. How large the spread should be is not disclosed in the record. Moreover, diamonds are not fungible in quality and one man's judgment does not always coincide with another's respecting the value of a particular parcel of diamonds. This means that after the diamonds are dispersed it is hard to get an expert opinion on market price except for certain standard sizes.

The man who buys for cash and sells on time can sometimes make some profit because of the differing terms of sale. It does not work the other way. There is no proof, however, that the bankrupt sold for prices that were objectively not fair consideration, for the fair price on a cash purchase may have been no more than what Freudmann got for the goods. What Freudmann paid for the goods himself may have been an excessive price which he was willing to pay to get the goods in his hands for conversion to needed cash. He may actually have sold for an adequate cash price on the market, though for him it was a sale at a loss. *Cf. Roth v. Fabrikant Bros. Inc.*, 175 F.2d 665, 667-68 (2 Cir. 1949; discussion of this problem by Judge A. N. Hand).

The Referee in his first opinion found that the bankrupt had an actual intent to defraud the vendor when the bankrupt immediately made a transfer of the merchandise bought for "inadequate consideration." When the bankrupt proved that he had actually paid some of these vendors in whole or in part, indicating that he presumably had no intent to fail to pay them for the particular purchases, the Referee clarified his reasoning to make the "defrauded" creditors the creditors who stood "at the end of the line."

Actual intent to defraud does not require an intent to defraud all creditors. *Kolesinski v. Mashey*, 127 F.2d 528 (2 Cir. 1942). It is enough if there is intent to defraud some creditors. And creditors "at the end of the line" presumably qualify as well as any other creditors. See *Moore v. Bay*, 284 U.S. 4 (1931).

We should not elide the difficulty, however. In *every* bankruptcy it is the creditors "at the end of the line" who are stuck. Merely incidental harm to creditors, such as generally accompanies preferential transfers, for example, is not enough to bar discharge. See *Cader v. Arts*, 213 U.S. 223, 243 (1909). See *Hayslip v. Long, supra*. See *In re Julius Bros.*, 217 Fed. 3 (CCA2 1914).

The particular bar to discharge here invoked is of ancient origin. It derives from the early Statute of Elizabeth dealing with fraudulent conveyances which included the words "intent to delay, hinder or defraud creditors." 13 Eliz. C.5. These words are still in §14c(4) of the Bankruptcy Act, as they were in the 1898 Act. "The real test of a fraudulent conveyance . . . is the unjust diminution of the debtor's estate." I Glenn, *Fraudulent Conveyances and Preferences*, §195 at 348 (rev. ed. 1940).

The question whether a particular transfer is a fraudulent conveyance comes up in several ways in the Bankruptcy Act. It may be an act of bankruptcy under §3a. It may be a transfer voidable by creditors and by the trustee under §§67d and e, and §70e. It may bar a discharge under §14c(4).

Thus, a transfer may not be voidable against a bona fide transferee for value and yet be intended by the bankrupt to defraud creditors. See *Cader v. Arts, supra* at 242: " . . . it makes no difference that the conveyance was made upon a

valuable consideration, if made for the purpose of hindering, delaying or defrauding creditors."

While the trustee here probably would not succeed in a proceeding under §67 to recover the diamonds sold for cash because of inability to show inadequacy of consideration, that does not prevent the transfer from being one made with intent to defraud creditors. A transfer not voidable against a buyer under §67e may still be a fraudulent transfer under §14c(4).

So too a preferential payment for an antecedent debt is not a bar to a discharge, see *Cader v. Arts, supra,* but "a transaction may be invalid both as a preference and as a fraudulent conveyance." *Dean v. Davis,* 242 U.S. 438, 444 (1917). The issue turns on proof of actual intent to defraud creditors.

The circumstantial evidence of intent in the law of fraudulent conveyances has long been categorized by certain patterns of conduct called for convenience "badges of fraud." In the language of Glenn (1 Glenn, *supra* §307a at 535):

> "There are many badges of fraud . . . Each, like vice, needs but to be seen, but no court, when properly advised, will endure them. In passing, however, we will mention a few of these items of mercantile wrongdoing that indicate the debtor's bad condition, and the grantee's bad faith if the facts are known to him. Thus, the persistent selling of merchandise at a loss, purchasing goods by a system of check kiting for resale at any figure obtainable . . . "

The use of another man's goods for the payment of the prospective bankrupt's debts is a badge of fraud. The rationale is that the intentional depletion of the bankrupt's estate by

transfers within a year of bankruptcy is an intentional defrauding of creditors. And depletion of the estate is the likely corollary to a practice of buying dear and selling cheap. As the Referee put it, "An entire series of such transactions [selling below cost] is the clearest indication to an intention to defraud" (1st Op. at 7).

That there may be a fraudulent transfer with intent to defraud creditors without proving an absence of fair consideration may also be gleaned from the present statutory language of §67d(2) (11 U.S.C. §107d(2)). The present section divides fraudulent transfers into four parts: (a) if made by a debtor who is thereby rendered insolvent; (b) if the property remaining leaves him with unreasonably small capital; (c) if the debtor believes he will incur debts beyond his ability to pay as they mature; and (d) if made with actual intent to hinder, delay or defraud other existing or future creditors.

In each of the first three categories there is a statutory element requiring that the transfer be made "without fair consideration." In the case of the fourth category the old fraudulent conveyance language is used, and there is no requirement that the transfer be "without fair consideration" so long as there is an actual intent to defraud.

While I cannot find that there is adequate proof in this record that the cash sales were "without fair consideration," it is my opinion that the evidence adequately supports Referee Herzog's ultimate finding that the bankrupt actually intended to defraud his creditors by fraudulent transfers. Discharge was properly denied.

The petition for review is denied.

M.L. GURFEIN
U.S.D.J.

Dated: July 3, 1973.

1. §14c reads in pertinent part as follows:
"(c) The court shall grant the discharge unless satisfied that the bankrupt has . . . (4) at any time subsequent to the first day of the twelve months immediately preceding the filing of the petition in bankruptcy, transferred, removed, destroyed, or concealed, or permitted to be removed, destroyed, or concealed, any of his property, with intent to hinder, delay, or defraud his creditors; . . . "